C5805-5-U

October 1987

THE 29th ANNUAL McGRAW-HILL SURVEY OF OVERSEAS OPERATIONS OF U.S. INDUSTRIAL COMPANIES, 1987-88

by Sara Johnson

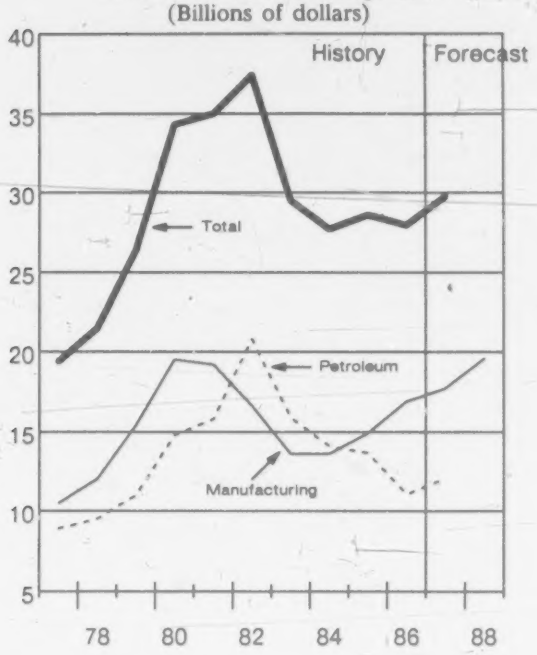
After a period of retrenchment, American businesses are raising their commitment to foreign operations. According to the 29th Annual DRI/McGraw-Hill Survey of Overseas Operations of U.S. Industrial Companies, majority-owned affiliates of U.S. manufacturing and petroleum firms plan to increase spending on plant and equipment 6.4%, to $29.8 billion, in 1987. Expectations of rising profitability and expanding markets, as well as the rebound in oil prices, are motivating forces behind their investment decisions. Although the dollar's depreciation has shifted the competitive balance in favor of the United States, manufacturing companies are continuing to invest in overseas operations to diversify their sources of supply.

Last year, capital expenditures by foreign affiliates declined 2.2% to $28.0 billion, with a 19.1% cutback by petroleum companies overshadowing a 13.3% increase by manufacturers. The 1986 result for manufacturing investment was very close to last year's DRI/McGraw-Hill survey results, which predicted a 14.0% advance. The pullback in the petroleum industry was sharper than the 14.3% decline anticipated a year ago, but this outcome is not surprising in the aftermath of a 47% plunge in oil prices.

Manufacturing affiliates plan to raise investment abroad 4.8% this year (to $17.7 billion), followed by a heftier 10.5% increase (to $19.6 billion) in 1988. Despite the upward trend, capital outlays will fall short of the $19.5 billion peak reached in 1980 (Chart 1). In 1987, the chemical and electrical machinery industries plan the largest spending increases; in 1988, the industry leaders will be food and beverages, chemicals, and transportation equipment. Manufacturers are stepping up investment next year despite weaker sales expectations: after an estimated sales increase of 11.9% this year, manufacturing affiliates anticipate only a 5.1% sales gain in 1988.

Overseas investment by petroleum companies was slashed from a high of $20.8 billion in 1982 to just $11.1 billion in 1986 as falling prices depressed expected returns on exploration and development. Cash

Chart 1
Overseas Capital Spending
of U.S. Industrial Companies
(Billions of dollars)



flow problems contributed to the postponement of oil and gas development projects in the North Sea and Canada. With crude oil prices rebounding 27% in 1987, however, the industry outlook is brightening: petroleum affiliates plan to boost capital outlays 9.0%, to $12.1 billion, this year. The Middle East, North Sea, and Canada are the principal beneficiaries. Because of the recent volatility of oil prices, companies surveyed were unable to provide estimates of 1988 investment.

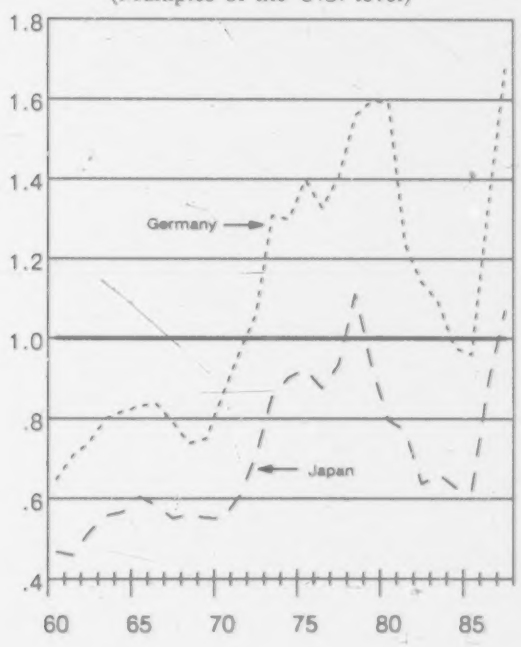
These are the major findings of the DRI/McGraw-Hill survey of overseas investment, conducted from July through early September. The companies responding to the survey account for 26% of capital spending by all majority-owned foreign affiliates of U.S. firms. The dollar amounts cited in this report represent foreign investment by all U.S. industrial affiliates, not just those companies included in the survey. Because of the small number of responses, the metals industry is not shown separately but is included with the "other manufacturing" category.

THE DOLLAR'S FALL SHIFTS THE COMPETITIVE BALANCE

By improving the price competitiveness of domestic operations relative to their foreign counterparts, the dollar's depreciation has contributed to a slowdown in overseas investment by manufacturers. By August 1987, the dollar's real exchange value had fallen sharply from its March 1985 peak against the currencies of Japan (-32%), Germany (-32%), France (-38%), the United Kingdom (-28%), and Taiwan (-17%); moderate declines were recorded against the Canadian dollar (-6%) and the Korean won (-5%). In contrast, the inflation-adjusted dollar appreciated 19% against the Mexican peso over this 27-month period.

As a result of these exchange rate movements, U.S. manufacturers currently enjoy a significant cost advantage over their European competitors, and have achieved parity with the Japanese. Germany's unit labor costs in manufacturing industries now exceed U.S. costs by 70%; this disadvantage reflects lower labor productivity and higher hourly compensation. Japan's unit labor costs in manufacturing have soared from just 62% of the U.S. level in 1985 to 107% of U.S. costs in 1987 (Chart 2).

Chart 2
Foreign Unit Labor Costs in Manufacturing
(Multiples of the U.S. level)

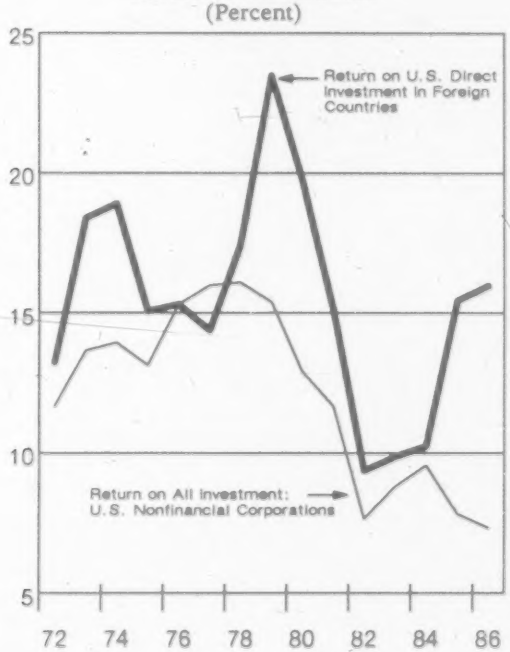


The projected increase in overseas investment in Europe is somewhat surprising in light of these cost comparisons. Europe's share of investment by U.S. manufacturing affiliates is expected to rise from 54% of overseas spending in 1986 to 58% in 1988. One explanation may be that Europe's comparatively high labor costs are an incentive to modernize facilities and achieve lower costs through higher productivity. On the other hand, the dollar's depreciation has increased the dollar prices of plant and equipment purchased in foreign currencies. After accounting for inflation, the nominal spending increase projected for this year might actually represent a decline in the real level of investment.

FAVORABLE RATES OF RETURN ENCOURAGE OVERSEAS INVESTMENT

The rate of return on U.S. direct investment in foreign countries averaged 15.1% before taxes over the past 10 years, and reached 16.0% in 1986 (Chart 3). By comparison, U.S. nonfinancial corporations realized an average 11.3% return on all capital investments over the past decade. Thus, foreign investments have generally outperformed investments in domestic operations. (It is interesting to note that the return on foreign direct investment in the United States averaged just 8.2% over the past 10 years, dropping to 3.2% in 1986.)

Chart 3
Comparison of Before-Tax Rates of Return on Investment
(Percent)



The firms surveyed, however, perceive their profit margins on sales as similar for foreign and domestic operations. In 1987, the petroleum, transportation equipment, and electrical machinery industries expect higher profit margins from foreign subsidiaries than from domestic units, while the food and chemical industries report lower margins on foreign operations than on domestic operations.

Overseas investment plans are driven by expectations of rising profitability. In 1987, 62% of responding companies expect an increase in profit margins of overseas units, while only 12% expect a decrease. The upswing is projected to continue into 1988, when 53% of companies anticipate an improvement in profit margins and just 13% expect a deterioration. Companies in the electrical machinery, petroleum, and chemical industries are the most optimistic about future profitability.

THE BIG SPENDERS IN MANUFACTURING

The 4.8% increase in manufacturing affiliates' investment this year is led by double-digit gains in chemicals and electrical machinery. After undertaking major investments in 1985 and 1986, transportation equipment companies will stabilize their spending this year before pushing it up again in 1988. Food and beverage companies are currently retrenching but plan a strong comeback next year. Among industries, the major investors in 1987 are petroleum ($12.1 billion), transportation equipment ($4.3 billion), and chemicals ($3.7 billion).

After soaring 40% in 1985 and 30% in 1986, spending by foreign affiliates of transportation equipment manufacturers should increase 1.7% in 1987 and 17.9% in 1988. This year's investment will be stepped up in Canada, Europe, and Australia as plants are retooled. One automaker plans to begin exporting sports cars from Australia. Weak demand and excess capacity in North America will force a cutback in Canadian investment in 1988. The sharp drop-off in Latin American investment reflects the completion of a Mexican plant in 1986. With new labor contracts guaranteeing employment for U.S. workers, future opportunities for outsourcing components will be limited.

The rebound in prices of energy feedstocks has not deterred chemical manufacturers. Building on a 16.6% increase in 1986, chemical producers will boost overseas investment 16.4% in 1987 and 18.1% in 1988. Producers of industrial chemicals, drugs, and fertilizers are expanding capacity in Latin America, the Pacific Basin, and Europe. Pharmaceutical companies have put investments in Canada on hold, pending approval of legislation providing 10 years of patent protection.

After two years of no growth, foreign investment in the electrical machinery industry is slated to rise 14.0% this year and 3.5% in 1988. This year, American companies are focusing their investments in Europe: in 1988, though, additional funds will begin flowing to East Asia, where the newly industrialized countries have gained a competitive edge with cheap labor.

The 3.8% rise in overseas investment by non-electrical machinery companies ends five years of retrenchment. Despite buoyant sales expectations, the downward trend in capital spending will resume in 1988. The companies surveyed produce computers, heavy machinery, automation systems, and defense equipment. Investments are concentrated in Europe, where currency appreciation is putting downward pressure on profit margins.

Disappointing returns on earlier investments prompted food and beverage companies to trim overseas investment 4.6% this year. After surprisingly strong sales gains in 1987, capital spending is expected to rebound 20.0% in 1988. Reflecting currency realignments, the food industry is shifting its investments from Europe to Canada, Latin America, and East Asia. "Other manufacturing," which includes paper, metals, apparel, minerals, and office equipment, plans a 1.0% reduction in overseas investment this year, followed by a 4.3% rebound in 1988.

INVESTMENT SHIFTS TO EAST ASIA

While Europe continues to attract the lion's share of foreign investment by U.S. companies, the most rapid increases are in the Pacific basin. Investment in Canada is holding steady, while Latin American affiliates are cutting back in 1987.

Manufacturing affiliates plan to increase investment in EEC countries 7.1% this year and 14.8% in 1988. Although currency appreciation has impaired European competitiveness in the world market, domestic demand is growing in response to interest rate reductions and tax cuts. A shortage of skilled labor will continue to put upward pressure on wages, encouraging firms to invest in more efficient plant and equipment.

Attracted by the region's strong growth prospects, American manufacturing companies are beginning to invest in the Pacific basin. Manufacturing affiliates in Japan and other East Asian countries plan to raise capital outlays 9.9% in 1987 and 14.0% in 1988. Led by export gains, the newly industrialized countries are achieving growth rates of over 6% annually. Although capital controls limit investment opportunities in Korea, other nations (Taiwan, Singapore, and Hong Kong) are receptive to foreign investment.

Investment by manufacturing affiliates in Latin America is scheduled to fall 9.0% in 1987 before recovering 4.6% next year. The automobile industry is slashing capital outlays, while most other industries are planning increases. Investment by petroleum affiliates is expected to advance a strong 11.5% in 1987. Barriers to foreign investment are coming down, and an infusion of direct investment is essential to ease the region's debt problem. Economic growth remains sluggish, however: real GNP in Latin America is projected to rise just 2.5% this year and 3.1% in 1988.

Investment in Canada will rise 3.4% this year, with petroleum companies leading the way. Manufacturing affiliates plan to hold spending near 1986 levels. With the recent success of free trade negotiations, U.S. firms may increase their investment spending in Canada.

Table 1
Plans for Capital Spending
(Millions of dollars)

Industry	Level			Percent Change		
	1986	1987	1988	1986	1987	1988
Nonelectrical Machinery.	2,968.0	3,081.0	3,020.1	-1.6	3.8	-2.0
Electrical Machinery....	1,429.0	1,629.5	1,685.8	0.3	14.0	3.5
Transportation Equipment	4,233.0	4,305.1	5,075.2	29.8	1.7	17.9
Chemicals.....	3,198.0	3,721.2	4,394.8	16.6	16.4	18.1
Food & Beverages.....	1,408.0	1,342.7	1,610.6	16.0	-4.6	20.0
Other Manufacturing.....	3,673.0	3,634.5	3,789.7	12.5	-1.0	4.3
ALL MANUFACTURING.....	16,909.0	17,713.9	19,576.1	13.3	4.8	10.5
Petroleum.....	11,055.0	12,053.3		-19.1	9.0	
ALL INDUSTRY.....	27,964.0	29,767.3		-2.2	6.4	

Table 2
Overseas Capital Expenditures By Regions
(Millions of dollars)

Industry	CANADA			LATIN AMERICA			EEC*			EUROPE OTHER THAN EEC		
		Planned			Planned			Planned			Planned	
	1986	1987	1988	1986	1987	1988	1986	1987	1988	1986	1987	1988
Nonelectrical Machinery.	225	233	229	294	305	299	1,947	2,019	1,981	64	70	65
Electrical Machinery....	143	111	149	140	174	178	668	875	842	47	34	40
Transportation Equipment	1,470	1,709	1,523	617	167	49	1,848	1,998	3,070	11	10	11
Chemicals.....	549	531	521	364	520	607	1,803	1,919	2,408	34	58	129
Food & Beverage.....	202	238	394	203	160	286	826	806	633	15	10	13
Other Manufacturing.....	934	685	733	551	649	647	1,797	1,903	1,995	94	111	116
ALL MANUFACTURING.....	3,523	3,508	3,550	2,169	1,974	2,065	8,889	9,521	10,930	265	294	375
Petroleum.....	1,659	1,849		809	902		3,868	3,905		809	1,023	
ALL INDUSTRY.....	5,182	5,358		2,978	2,876		12,757	13,426		1,074	1,317	

Industry	MIDDLE EAST			AUSTRALIA, NEW ZEALAND, SOUTH AFRICA			JAPAN-ASIA (OTHER THAN MIDDLE EAST)		
		Planned			Planned			Planned	
	1986	1987	1988	1986	1987	1988	1986	1987	1988
Nonelectrical Machinery.	0	0	0	152	158	155	286	297	291
Electrical Machinery....	15	17	18	22	27	27	390	389	429
Transportation Equipment	0	0	0	247	366	385	39	55	37
Chemicals.....	3	0	0	214	386	300	218	291	410
Food & Beverage.....	0	0	0	102	39	145	54	86	128
Other Manufacturing.....	1	0	0	59	58	62	225	215	224
ALL MANUFACTURING.....	19	17	18	796	1,034	1,075	1,212	1,332	1,518
Petroleum.....	366	573		633	801		1,622	1,637	
ALL INDUSTRY.....	385	591		1,429	1,835		2,834	2,969	

Industry	AFRICA (OTHER THAN MIDDLE EAST AND SOUTH AFRICA)		
		Planned	
	1986	1987	1988
Nonelectrical Machinery.	0	0	0
Electrical Machinery....	2	2	2
Transportation Equipment	0	0	0
Chemicals.....	14	16	19
Food & Beverage.....	8	3	11
Other Manufacturing.....	12	11	12
ALL MANUFACTURING.....	36	33	45
Petroleum.....	1,050	1,363	
ALL INDUSTRY.....	1,086	1,395	

*Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, United Kingdom.

Table 3
Capital Expendiutures For Property, Buildings and Equipment
(Percent of total)

Industry	Estimated 1986			Planned 1987			Planned 1988		
	Property	Buildings	Machinery & Equipment	Property	Buildings	Machinery & Equipment	Property	Buildings	Machinery & Equipment
Nonelectrical Machinery.	1	14	85	0	10	89	0	9	91
Electrical Machinery....	2	35	63	0	20	80	0	20	80
Transportation Equipment	1	15	84	1	15	84	1	15	84
Chemicals.....	3	15	81	3	15	81	3	14	83
Food & Beverage.....	3	8	89	0	0	100	0	0	100
Other Manufacturing.....	1	12	87	1	11	88	2	21	77
ALL MANUFACTURING.....	2	15	84	1	14	85	1	15	84
Petroleum.....	0	0	100	0	0	100			
ALL INDUSTRY.....	1	14	85	1	13	86			

Table 4
Expected Profit Margins On Sales
Overseas Subsidiaries vs. U.S.

INDUSTRY	1987 % of Companies Answering			1988 % of Companies Answering		
	Higher	Lower	Same	Higher	Lower	Same
Nonelectrical Machinery.	50	50	0	50	50	0
Electrical Machinery....	60	40	0	60	40	0
Transportation Equipment	60	40	0	60	40	0
Chemicals.....	22	44	33	38	38	25
Food & Beverage.....	0	80	20	0	60	40
Other Manufacturing.....	60	20	20	50	25	25
ALL MANUFACTURING.....	39	45	16	41	41	17
Petroleum.....	67	0	33	100	0	0
ALL INDUSTRY.....	41	41	18	43	40	17

Table 5
Expected Overseas Profit Margins On Sales
1986 vs. 1985, 1987 vs. 1986

INDUSTRY	---1987 vs. 1986--- % of Companies Answering Higher	Lower	Same	---1988 vs. 1987--- % of Companies Answering Higher	Lower	Same
Nonelectrical Machinery.	50	50	0	0	50	50
Electrical Machinery....	80	0	20	100	0	0
Transportation Equipment	40	0	60	20	40	40
Chemicals.....	56	22	22	63	13	25
Food & Beverage.....	60	20	20	40	0	60
Other Manufacturing.....	80	0	20	50	0	50
ALL MANUFACTURING.....	61	13	26	52	14	34
Petroleum.....	67	0	33	100	0	0
ALL INDUSTRY.....	62	12	26	53	13	33

Table 6
Expected Sales Of Foreign Affiliates
(Percent change)

	1986-87	1987-88
Nonelectrical Machinery.	17.1	12.9
Electrical Machinery....	11.1	7.6
Transportation Equipment	10.1	0.1
Chemicals.....	8.9	6.9
Food & Beverages.....	19.1	9.9
Other Manufacturing.....	15.1	13.6
TOTAL MANUFACTURING.....	11.9	5.1